MONETARY STABILITY VERSUS FINANCIAL STABILITY IN ADJUSTING THE REAL ECONOMY

Boldea Bogdan

Gheorghe Roxana Maria

Ivanovici Daniela Cecilia

Strezariu Iulia Ana-Maria
Universitatea de Vest din Timişoara
Facultatea de Economie şi de Administrare a Afacerilor

Nowadays, in the economic theory and practice, there's commonly held idea that the primary objective of monetary policy should be price stability. However, the possibility of achieving this goal depends on the development and stability of the financial system. Even though financial stability represents a prerequisite for reaching the objective of price stability, the relationship manifests itself in reverse also.
In the long term, the two objectives support and reinforce each other, but in the short term, there may occur certain incompatibilities, thus resulting in the central bank's dilemma of abandoning one in favor of the other.
This paper aims to investigate precisely the circumstances in which the policies pursued to ensure price stability can cause or worsen financial stability.

Keywords: price stability, financial stability, central bank, monetary policy, National Bank of Romania
JEL Classification: E31, E52, E58, G01

Modern economies must cope with the challenge of achieving financial stability, given that the globalizing financial environment is becoming more complex due to globalization, to the intersection of the monetary and financial market, and to the financial industry innovativeness. Although this evolution of the markets encourages more efficient allocation of global capital resources, allowing the ways of financing to adapt more quickly to the needs of the real economy, "the financial sector is not exempt from tensions and destabilizing movements, which generate risks not only for the players of the financial sector, but also for the economy as a whole".
Thus, most of contemporary economists have reached consensus on the importance of the central banks (CB) in ensuring financial stability. Missing this goal may cancel the monetary authority performances in achieving its ultimate objective priority – price stability.
Through the years, the CB activity has oriented its monetary policy on various objectives. In the 70s – 80s, the CB were particularly concerned with stimulating the economic growth, their main role being that of providing liquidity and monetary supply expansion through bank refinancing (active monetary policy). Since the early 80s, CB have focused on the objective concerning price stability (the new monetary policy), and currently, financial stability has become again an important objective in the economic decision making process, mainly due to the liberalization of capital flows and to the emergence of economic and financial crises.
Therefore, in our opinion, financial stability is no fresh news to economy, but a retrieval of a traditional issue.
It is required a delimitation of the two concepts – "price stability" and "financial stability" – taking into account the existence of multiple definitions concerning the first concept and the lack of universally accepted definitions for the second one.

After analyzing some definitions from the specialty literature for clarifying the two concepts, we considered the ECB's[434] vision relevant with respective to price stability and the paper "Financial Stability", in what concerns the definition given to financial stability[435].

The ECB's vision concerning price stability is the following: 'price stability is defined as the state of economy when the general price level is stable in the strict sense or when the inflation rate is sufficiently low and stable, so that considerations related to the nominal dimension of transactions cease to constitute a relevant factor for the economic decisions".

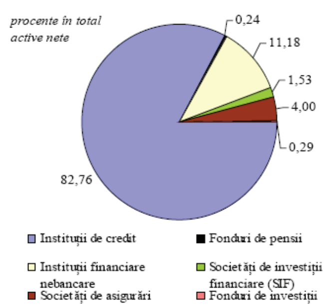
In Romania, price stability represents the objective of the National Bank of Romania's strategy: direct inflation targeting. The aim of this strategy is reaching the optimal level of inflation, which can contribute to sustainable economic growth, macroeconomic stability, and last but not least, to ensuring a high level of social welfare.

Unlike price stability, there is no universally valid definition of financial stability. The following genus-differentia definition of 'financial stability' better satisfies the requirements of formal logics: "financial stability is the feature of the financial system which subsists in its capacity of absorbing the financial imbalances that occur endogenously or due to exogenous, significant and unanticipated event, thus facilitating the achievement of economic performances".

Authors such as J. Chant refer to this concept starting from the opposite term: 'financial instability'. "Financial instability refers to the financial markets, conditions which affect or threaten to affect the economic performances through their impact over the financial system".

In the broad sense, financial stability implies that the financial system must be "able of attracting and placing funds efficiently and of withstanding shocks without hurting the real economy", while in the restricted sense, specific to the banking sector, financial stability relates to the situation characterized by a lack of banking crises and the existence of a certain level of assets price stability, including the interest rates.

Thus, the concept of 'financial stability' appears as a feature of the financial system, which includes the financial market, financial institutions and their related infrastructure. As a consequence of the many links among these components (markets, institutions and infrastructure), any imbalance in either of the elements may affect the others, thus compromising the stability of the whole system. However, if the system works well enough to perform its core functions, even when one of the components faces problems, they do not necessarily constitute a threat to overall stability. This means that it is not mandatory for all the elements to operate at / near maximum at any time.



A stable financial system has the capacity to limit or to solve imbalances, partly through self-control mechanisms, before leading to crises (in which case, financial stability and monetary stability are achieved simultaneously). Therefore, we must speak of both global perspective and a systemic one, in measuring the soundness of the financial system.

[434] European Central Bank.

[435] In our paper, we will refer to the two concepts considering these definitions, as they are the most adequate, in our opinion.

When it comes to Romania, we must highlight the fact that it still shows the features of an emerging financial market. In 2008, financial and non-bank financial institutions continued to hold the largest share of total financial assets, being in slight increase up to 93,9%, while the insurance and capital markets account for only 6,1% of total net assets.

Consequently, the impact over the stability of the entire financial system, caused by failures in the banking sector, would be much higher than if it were provoked by problems of any of the components of the financial sector (Chart 1 – Structure of the financial system in Romania), so they must be efficiently supervised.

Bank supervision plays a very important part in ensuring both financial and monetary stability because the banking sector is the main transmission channel of monetary policy. Therefore, if it recorded imbalances (liquidity deficit or surplus), it would be very difficult for the CB to fulfill their objectives.

In our view, bank regulation and supervision is vital in maintaining price stability because the micro and macro-prudential information obtained by practicing this function may be successfully used in preventing or managing crises which could negatively affect the main objective of the CB, taken into account the repercussions on the real economy.

Usually, financial stability does not represent an explicit objective for modern central banks, but they begin to show a particular interest in achieving their main objective: to ensure currency stability. Monetary policy can not be fully effective unless it is based on foreseeable transmission mechanisms, which implies a sufficiently stable financial environment. Mutually, price stability is a necessary condition in ensuring financial stability, but not sufficient. In our opinion, there are certain circumstances when some unpredictable transmission mechanisms may also have a high efficiency.

A well-functioning financial system allows an economy to exploit the full potential of growth because it provides the necessary funds for investment opportunities at minimal costs. Also, a stable financial system facilitates the economic performances improvement and contributes in correcting imbalances that affect the economy. However, this concept should be perceived dynamically. This means that resources must be permanently mobilized, and once stability is reached, a more lax policy should not be adopted, instead, it should be operated with different levers to maintain stability, because the financial system is in a permanent qualitative change.

But still, could the policies pursued to achieve monetary stability (restrictive policies), cause or even worsen financial instability, in certain circumstances? The answer to this question, somehow rhetorical, is the objective of this research.

Regarding the relationship between price stability and financial stability, in the literature there were formulated two approaches: *the conventional approach* – according to which, the two types of stability support and reinforce each other, in the long term - and the *"new environment" hypothesis* – which holds the idea that along with controlling inflation at low levels, a new economic environment is developed and financial stability is not guaranteed anymore.

We subscribe to the idea that the two objectives are compatible in the long term, but in what concerns concrete monetary policy, short term outlook is targeted, in detriment of the former. Such conflicts may arise between the two concepts within the meaning of disclaiming one for another.

The interest rate monetary policy is one of the main tools used by CB to ensure financial stability. To illustrate, in an economic scenario with two variables - high inflation and fragile banking system – in order to combat high levels of inflation CB may increase the nominal rate of reference interest rate, thus causing higher instability of the banking system.

Therefore, we can talk about an incompatibility between the policies pursued in the short term to ensure price stability, respectively financial stability. Interest rate variations induced by CB in the monetary market triggers a series of mechanisms, having a strong influence on the population and enterprises decisions of consumption, savings and investment.

In caeteribus paribus terms, a higher interest rate will lead to a contraction in the consumer and investment credit in what concerns the population, respectively the businesses, thus affecting the already installed fragility of the banking system. Also, the population will be encouraged to save, in detriment of investing, these chain effects, finally, having an impact on other real economy variables, like production and correlative volume of imports and exports.

On the one hand, from the households' point of view, an increase in real interest rates above the growth of differential inflation rate increases the attractiveness of saving because the efficiency is higher in terms of future consumption, resulting therefore in lower current consumption. Furthermore, regarding an enterprise, a higher rate of interest will have inhibitory effect on investments because there will be fewer investment projects available to provide sufficient performance to cover the increased costs of capital.

The connection between monetary policy and bank stability does not inhere exclusively in the level and volatility of interest rates. A more general tension is that the cyclical effects of monetary policy and bank regulation push in opposite directions. Monetary policy tends to move in countercyclical fashion: in the event of an economic slowdown, the central bank may expand the money supply and provide more funds to speed up the economy's recovery. However, the effects of bank regulation—especially prudential regulation, such as capital adequacy requirements—are procyclical, requiring a contraction of banking activity when the economy slows. For example, during a recession, a bank regulator might require an increase in loan-loss reserves and an improvement in the quality of banks' lending portfolios.

A second argument of the incompatibility between monetary policy and financial stability is reflected in the literature of ideas set out by various authors who disagree with CB involvement in regulatory and supervisory activities. The supported idea is establishing a Single Supervisory Authority (SSA), responsible for the stock exchange, insurance sector and banking supervision, thus absolving CB from regulatory and supervisory function of the banking sector.

The main argument used by the authors in question is the possible conflict that may arise between the objective of financial stability (achieved mainly through this function) and the objective of monetary policy, for instance, in a crisis, when CB should not be concerned only with the inflation targeting, but with ensuring the stability of the financial and banking system by/through injecting cash in order to rescue financial institutions which are in difficulty (it will choose "the least bad").

We consider that a SSA is justified if the stock market would be developed or it would be difficult to define each financial sector's activities, and not based on the incompatibility theory between banking supervision and the objective of monetary policy. In Romania, the supervision unification is not appropriate now, given that the Romanian financial system is characterized by a low degree of intermediation, insurance and financial investment are underdeveloped, the banking sector having a significant weight.

Although, in the short term, a compromise between monetary stability and financial stability can be reached, we consider necessary to keep the banking supervisory function as an attribute of CB, because macroeconomic forecasts can be improved when based on confidential information obtained from prudential controls on credit institutions.

A third argument of the incompatibility between monetary stability and financial stability, identified in the literature, is the very complexity of the two objectives. If price stability is the main goal of many modern CB, it can be well defined, achieved and maintained over time, financial stability is more complex, both by the different opinions on its definition, and by the many ways of achieving it, as by the importance that some authors assign to this concept in light of the economic context. Financial stability depends both on endogenous factors, such as: real economy movement, relations with foreign countries, operational risk, domino effect, etc., and exogenous factors: macroeconomic disturbances, natural disasters, large business failures.

Since august 2005 NBR's attention has focused, in particular, on the objective of price stability, due to increased inflation expectations and national currency appreciation caused by massive capital inflows (direct investments, portfolio investments, return of labor incomes). Between 2005-2007, NBR fulfilled the net debtor position towards the banking system when increases of the interest rate, needed to bring expectations in line with the inflation target , were attracting more foreign capital, and appreciating the national currency unsustainably ("Tosovsky dilemma").

From the onset of the financial crises in July 2007, NBR aims to be a net creditor of the banking system, foreign capital inflows being significantly attenuated. The reduction of external funding led to national currency depreciation, which increases inflation and requires a relatively high nominal interest rate. Due to the exponential growth in consumer credit recorded in the period 2005-2008, the main affected by the depreciation of the national currency are the borrowers in euro and currencies, who do not register a debt service as good as the previous, thereby assist in increasing the vulnerability of the financial system. Although it is necessary increasing the interest rate, this may decelerate economic growth and, moreover, could lead to the augmentation of contracted credit costs and also of the possibility of converting them in nonperforming loans, with the risk of destabilizing the financial sector. Under these conditions, the compromise between the monetary policy objectives (price stability and financial stability) appears.

In modern economies, a low and stable inflation level leads to a new economic environment in which financial stability is not guaranteed and so the reconsideration of the relationship between price stability and financial stability is strictly required. So, there can be identified a fourth argument for the incompatibility of the two objectives, namely: the "new environment" hypothesis.

The cases of Asian countries during 1997-1998 were relevant in this direction. In the period preceding the onset of a financial crisis, these economies had experienced significant imbalances, despite the existence of a relatively high degree of price stability. The same situation/case is observed with current financial and economic crisis in which CB were forced to inject a considerable amount of cash to maintain financial systems in operation. So, CB are no longer able to ensure both price stability and financial stability, in the event that their implementation requires contradictory measures.

Analyzing the case of Romania, we can affirm that maintaining financial stability has a particular importance to price stability, being primary considered regarding an alert process of disinflation. During 2000-2007, financial instability had been avoided through a proper dose of the disinflation rate, thus recording an average rate of disinflation of 5.8% per year, while maintaining financial system stability, which shows that, although both objectives, on short term, can be in contradiction, on the long term, they sustain and highlight each other (conventional approach). Failure in maintaining financial stability can only lead to an inflation growth.

The long term objective of monetary policy should be to achieve a low and stable inflation which helps long-term sustainable growth. Accordingly, low and stable inflation represents a goal in itself and also a way of achieving sustainable economic growth. The effectiveness of monetary policy in achieving this objective is limited by the level of financial stability.

As shown above, we can affirm that if financial stability is a condition for achieving the objective of price stability, the dependency relationship between them manifests also in reverse.

At the end of 2005, NBR adopted a series of "unorthodox" measures in order to limit the magnitude of the inflows impact on price stability and financial stability, such as: "cooling" - government credit growth which mitigates the phenomenon of overheating, that contributes to the reduction of inflationary pressures and limits external imbalances; reducing the growth rate of foreign currency component which prevents the increase of banks vulnerability to currency exchange rate fluctuations, that ensures the avoidance of an augmentation in the nonperforming loans volume.

The “unorthodox” measures which NBR adopted in 2005 and 2006 were primarily effective in the short term, ensuring reconciliation between financial and price stability. Since 2007, with Romania’s adhesion to EU, NBR has gradually dropped these restrictive measures which aimed especially the credit restriction.

But why were these measures so important? If NBR had not tried to restrict foreign currency loans, based on excessive appreciation of the national currency due to massive inflows of speculative capital, the population would have been tempted to overborrow in foreign currency. Since 2004 until August 2007, NBR has made relatively large purchases of foreign currency, being criticized that it had not left the course to appreciate in line with market requirements.

Often, high volatility of the exchange rate is associated with large current account deficits which are dangerous due to major implications primarily for monetary stability and generally for macroeconomic stability. Therefore, NBR adopts a floating current which allows CB interventions on the foreign exchange market, but without imposing them. It also reduces the possibility of speculative attacks on national currency, which intensified along with the liberalization of capital account.

The fact that CB does not assume a strict commitment rate and allows the market to set the exchange rate, represents both an advantage for financial system stability and a precondition of adhesion to ERM II.

In conclusion, we sustain the view according to which the policies designed to ensure price stability and financial stability have different intensities effects on the real economy, even if they can be implemented using similar tools by CB. Also, in our opinion, it is necessary to keep the regulatory and prudential supervisory function of the banking sector as an attribute of CB, because in this way micro- and macro-prudential information are obtained, information which contributes to the increase of monetary policy effectiveness.

We consider the arguments presented above as a reflection of the potential conflicts that may arise in the short term and/or very short term, between the two objectives, in the context of abandoning one for the other and not as a total incompatibility between them. Furthermore, we believe that, on the long term, the two objectives are interrelated, mutually sustaining and highlighting.

Analyzing the relationship between monetary stability and financial stability, we can affirm that there is a two-way link between them. Therefore, we believe that even if, in the long term, the primary objective of CB is, in general, price stability, they must pay attention also at financial stability. Otherwise, even if there is a progress regarding disinflation, their sustainability is not ensured in the context of an unstable financial system. Failure in maintaining financial stability can only lead to an inflation growth.

Bibliografy:

1. Băndoi, Anca, Tomiţă, I., *Stabilitatea financiară - coordonată a politicii monetare contemporane*, Finanţe - Provocările viitorului, Anul VII, Nr.8/2008, http://finante.ideaplussolutions.net/arhiva_detalii.php?idR=3 - accesat la10.12.2009;

2. Cerna, S., *Economie monetară*, Editura Universităţii de Vest, Timişoara, 2009;

3. Cerna, S., *Politica monetară şi criza financiară (I)*, Revista Română de Fiscalitate, nr. 12, decembrie 2008;

4. Cerna, S., Donath, Liliana, Şeulean, Victoria, Herbei, M., Bărglăzan, D., Boldea, B., *Stabilitatea financiară*, Editura Economică, Timişoara, 2008;

5. Chant, J., *Essay of financial stability*, Technical report No.95 , Bank of Canada, september 2003, http://www.banqueducanada.ca/en/res/tr/2003/tr95.pdf#page=19 - accesat la 21.01.2010;

6. Copelovitch, M., Singer, D., *Financial Regulation, Monetary Policy, and Inflation in the Industrialized World*, The Journal of Politics, Vol. 70, No. 3, 2008;

7. Gălvan, B., Anghel, Flavia, Bucur, Cristiana, *Monetary stability versus financial stability*, 2008,
http://steconomice.uoradea.ro/anale/volume/2008/v2-economy-and-business-administration/027.pdf - accesat la 25.02.2010;
8. Goodhart, C., Schoenmaker, D., *Institutional separation between supervisory and monetary agencies*, in F. Bruni (Eds), Universita Bocconi, Milano, 1993;
9. Isărescu, M., *Stabilitatea preţurilor şi stabilitatea financiară* – Disertaţie cu ocazia decernării titlului de „Doctor Honoris Causa al Universităţii din Piteşti”, Piteşti, 08.12.2006;
10.Isărescu, M., *Criza financiară internaţională şi provocări pentru politica monetară din România(II)*, nr. 756, 2009, www.topbussines.ro/romania/archive - accesat la 20.03.2010;
11.Issing, O., *Monetary and financial stability - Is there a trade off?*, martie 2003 http://www.ecb.int/press/key/date/2003/html/sp030329.en.html - accesat la 18.12.2009;
12.Gerdesmeier, D., *Price stability. Why is it important for you?*, Frankfurt pe Main, aprilie 2009,
http://www.ecb.int/pub/pdf/other/whypricestabilityen.pdf - accesat la 28.01.2010;
13. National Bank of Romania, *Report over Financial Stability* 2008;
14. Schinasi, G., J., *Preserving Financial Stability*, International Monetary Fund, Economic Issues, No.36, september 2005, http://www.imf.org/external/pubs/ft/issues/issues36/ei36.pdf - accesat la 12.03.2010;
15. Spulbăr, C., *Consideraţii privind rolul şi importanţa stabilităţii financiare în contextul integrării bancare europene*, Finanţe - provocările viitorului, Anul VII, Nr.7, 2008,
http://finante.ideaplussolutions.net/fisiere/revista/95978078817_SPULBAR_RO.pdf - accesat la 15.12.2009.